THE '92 ECONOMY • PENSION FUND THEFT • WORST BUSINESS GOOFS

JANUARY 13, 1992

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FORTUNE

CAN GM REMODEL ITSELF?

Inside the upheaval at the world's biggest manufacturer

CEO Robert Stempel cuts, cuts—and cuts still more.

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JANUARY 13, 1992 VOL. 125, NO. 1

FORTUNE

"The challenge for Stempel is to look people in the eye who may be his friends and tell them it's time to go home."
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ABOVE: Robert Stempel, photographed by Michael L. Abramson at the December news conference in which the GM chairman announced the elimination of thousands of jobs.

COVER: To salvage his company, Stempel will have to restructure radically. Photograph by William Coupon.

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The company can make great cars. But can it make money on them? As losses pile up and cash dwindles, CEO Robert Stempel has ordered significant cuts that will help get the company's payroll and production capacity more in line with its sales. However, salvaging General Motors will require not only reform but further upheaval. From instilling accountability to rationalizing the product line to getting tough with the union, sympathetic industry experts propose a number of steps GM may be wise to take to gain efficiency. Much is at stake, not only for GM but for the entire automotive industry and the U.S. economy. *by Alex Taylor III*

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"Consumers crave information, not another bloody marketing hyperbole. Give them the facts."

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EDITOR'S DESK

Chief forecaster Vivian Brownstein and editor Charles Burck

HOW'S BUSINESS? That's the question almost everybody is asking, and rarely has it been so hard to answer. Yet every day people facing tough markets must make decisions based not on the mood of the minute, but on the economy's future thrust. As senior editor Charles Burck puts it, "I cannot recall a time when people have been more anxious or uncertain." And that's an apt moment to offer you a guide to where the American economy is going.

The package beginning on page 36 contains our 18-month forecast, plus a detailed forecast for 19 key industries and a poll of FORTUNE 500 CEOs. Says executive editor Allan Demaree: "Ours is the only magazine with its own economists using our own economic models to produce our own forecasts. While we write about business as journalists, we also bring economic analysis to bear—in the same way an investment bank or the Congressional Budget Office would."

This is our first 18-month forecast since Vivian Brownstein, a veteran of our economic team, became FORTUNE's chief economist. Brownstein acknowledges a special challenge: "The gloom has been so pervasive that you have to assess how much it is affecting the real results." In separating the momentary mood from the underlying fundamentals, Brownstein was backed by economist Joseph Spiers, reporters Lenore Schiff and Lorraine Carson, and Todd May Jr., our former chief economist, who recently retired at 65.

Their analysis jibes with the views of the chief executives polled, who also foresee gradual strengthening—"a nice bit of corroboration," says Burck. And a nice bit of specific insight is the story on what lies ahead for major industries. It was prepared by reporters Stephanie Losee and John Labate, who interviewed scores of economists, security analysts, and executives.

After all the news on General Motors, what more can be said about the world's largest manufacturer? Well, quite a lot. Alex Taylor, a member of our board of editors, comes to the story with the perspective and sources gained through 14 years of following the auto industry. For months now he has been posing some basic questions: What are the prospects for GM's future, and what further changes may it productively make? For answers, see page 26.

Writer Alex Taylor analyzes GM's future.

Marshall Loeb

MANAGING EDITOR

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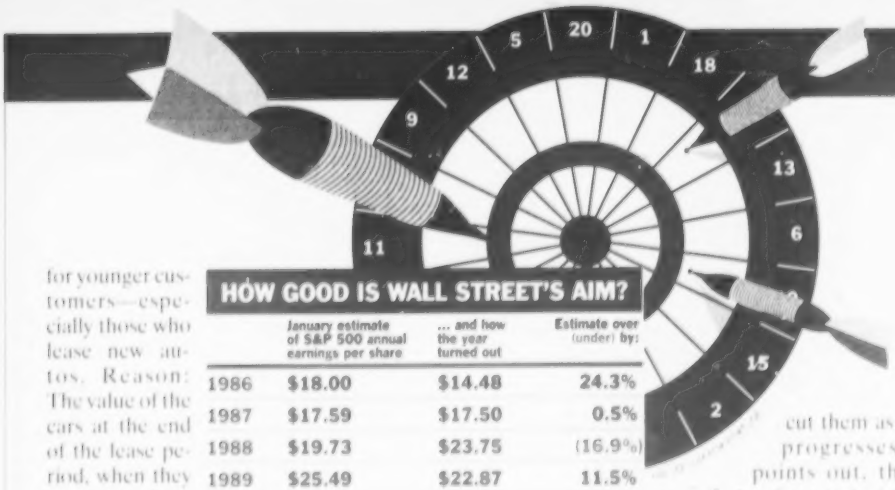


for younger customers—especially those who lease new autos. Reason: The value of the cars at the end of the lease period, when they are put back on the market, enables manufacturers and other leasing companies to charge less per month, even though the sticker price on Japanese autos is often higher. The table shows how this works for comparable four-door sedans leased for three years. Finance charges, about the same for each car, are not included.

Those who lease Japanese cars are 35, on average, and those who sign on for American ones, 39. And the Japanese, who got into leasing late, are quickly making up for lost time: Since 1989 they have increased their U.S. market share from 15.4% to 25.9%.

The Japanese are also building more customer loyalty than Detroit. According to CNW Marketing Research, which tracks leasing nationwide, 62% of first-time **Toyota** lessors buy or lease another, vs. a 39% repeat business for **General Motors**. (For more on GM, see Cover Story.) **– Rick Tetzeli**

The Accord LX holds its value.

WHY JAPAN'S CARS LEASE FOR LESS

	Monthly payment	Sticker price	Value held after 3 yrs. (%) ($)
Toyota Camry	$280	$15,980	37% ($5,913)
Chevrolet Lumina	**$294**	**$14,680**	**28% ($4,110)**
Ford Taurus GL	**$325**	**$16,480**	**29% ($4,779)**

FORTUNE TABLE / SOURCE: CNW MARKETING RESEARCH DATA BASE, 1992 MODEL YEAR

HOW GOOD IS WALL STREET'S AIM?

	January estimate of S&P 500 annual earnings per share	... and how the year turned out	Estimate over (under) by:
1986	$18.00	$14.48	24.3%
1987	$17.59	$17.50	0.5%
1988	$19.73	$23.75	(16.9%)
1989	$25.49	$22.87	11.5%
1990	$25.45	$21.34	19.3%
1991	$23.13	$18.00*	28.5%

BULL'S-EYE EVADES INVESTING PROS

■ If past is prologue, investors shouldn't put too much stock in the predictions of Wall Street's top strategists. They're the folk who look at macroeconomic trends while security analysts focus on individual companies. At the beginning of each year, some 25 strategists forecast what the S&P 500 will earn per share for the 12 months. But the average estimate rarely hits the mark (see table).

According to Zacks Investment Research, which tracks such predictions, last January the group predicted $23.13 for 1991. So far, that's about 28% higher than where the S&P seems likely to end up. Why the inaccuracy? Explains executive VP Ben Zacks: "The general nature of the whole investment community is to be optimistic because they're in the business of selling stock."

Patricia Shangkuan, a VP in Goldman Sachs's strategy group, concedes that strategists and, to an even greater extent, stock analysts tend to overestimate earnings initially and cut them as a year progresses. She points out, though, that a few strategists estimate profits from continuing operations before write-downs cut earnings. Adds she: "But even so, the estimates are too high. Part of the reason is that when we entered the recession the belief was that we'd bounce out quickly. The situation was worse than expected." **– A.J.M.**

St. Louis, whose Cardinals went to Phoenix in 1988, wants another team.

CORPORATE CHIEFS WANNA PLAY BALL

■ Forget the Super Bowl. The **National Football League**'s real big-money game took place recently when representatives from ten cities opened their play books to the league's expansion committee in hopes of gaining one of two new franchises to be awarded this year.

The cost of gridiron figures to be at least three touchdowns north of $100 million. The wannabe players: Baltimore, Charlotte, Jacksonville, Memphis, Nashville, Oakland, Raleigh-Durham, Sacramento, San Antonio, and St. Louis.

The NFL prohibits corporate ownership, but corporate biggies can still keep their eye on the ball. Examples:

From St. Louis came **Anheuser-Busch Cos.** executive VP Michael J. Roarty, who helped make the pitch for an ownership group that includes James B. (as in Busch) Orthwein, a board member for the brewer, and former Chicago Bears great Walter Payton.

Memphis countered with **Federal Express** CEO Fred Smith, fronting for an ownership squad that includes former Packer Willie D. Davis, now CEO of **All Pro Broadcasting**, a group of radio stations.

Baltimore has three competing groups. One includes Lenny Weinglass, chairman of the hot retailer **Merry-Go-Round Enterprises**. His challengers include spy book author Tom Clancy and Malcolm I. Glazer, owner of **First Allied**, a Florida investment firm.

The addition of an NFL club could add up to $450 million to

SPOTTING A BREAK IN THE CLOUDS

Top CEOs agree the economy is still in recession, though their own companies mostly are not. Their biggest peeve: President Bush's failure to act like a leader. ■ *by Richard S. Teitelbaum*

YES, the economy is now in a swoon—but the word from America's chief executives is that, despite relentless pessimism, the nation *could* be better off than many people think. More than half the FORTUNE 500 and Service 500 CEOs surveyed in our latest poll believe their own businesses are either on the mend or never felt the slowdown to begin with. Another 14% expect a pickup in the first half of 1992. That's the best news we've heard in a while, but it contrasts with the poll's finding that an overwhelming 69% feel the nation as a whole is still stuck in a recession. Reasons for the discrepancy—frequent in such surveys—remain elusive. Perhaps the CEOs are Pollyanas when it comes to their own shops; perhaps they're unduly downbeat about everyone else. Maybe their businesses are better than the economy in general.

Q A Has the national economy begun to recover from the recession?

Begun to recover	29%
Still in recession	69%
Not sure	2%

Q A Has your business started to recover?

Yes	30%
No	48%
Never had a slowdown	22%

Q A If not, when do you expect it to?

First half of 1992	29%
Second half of 1992	63%
Later	7%
Not sure	1%

To be sure, many executives do tend to paint rosy pictures of their own enterprises. Says John F. Fort of Tyco Laboratories: "Thirty percent of CEOs *never* admit their business isn't doing well." But others, like William J. Alley of American Brands, are willing to venture that gloom has gotten the better of their peers when it comes to gauging the national economy: "There may be something to what President Bush says, that it's not as bad as people think. So much depends on what economist you're listening to or what article you're reading or what part of the economy you're talking about." And Unocal's Richard J. Stegemeier states flatly: "I think the recession per se is exaggerated. I'm not referring to the man out of work, who feels it most, but the country in general."

Those who say their business is still in the dumps don't see a quick turnaround. Sixty-three percent expect to wait until the second half, while 7% feel a rebound won't come until 1993—or later. Frank A. Olson of Hertz Corp. points to the enormous debt that remains to be paid down and the structural problems of the financial sector. "The banks are trying to build their capital bases, so they are not lending money," he says. "It's going to take four to five years for us to dig out entirely." And even President Bush has backed off on his insistence that the economy is on the rebound.

Still, about a third of those now suffering expect a pickup in the first half of 1992. Amos R. McMullian of Flowers Industries, a food company, thinks his business is a leading indicator. Says he: "We're just, just seeing the beginning of a turnaround."

FORTUNE's latest poll was conducted between December 4 and December 12, before the Fed's big discount rate cut, by the independent opinion research firm of Clark Martire & Bartolomeo. The respondents included 200 chief executives of FORTUNE 500 and Service 500 companies. Their replies shed a little light on the layoff wave currently grabbing headlines. They were three times as likely to be cutting back on staff as to be hiring. A solid 58% described their employment as "holding steady"—a figure to keep in mind as restructuring announcements continue. But of those who aren't hiring, only 44% expect to resume in 1992. In 1993, 60% will be hiring.

When the subject turns to how Bush is

"The U.S. is not going to hell in a handbasket. Our industries will emerge stronger than ever from this recession."

WILLIAM J. ALLEY
American Brands

Q A Which of these comes closest to describing the employment situation at your company?

We are cutting back on staff	30%
We are hiring	10%
We are holding steady	58%
No answer	2%

PHOTOGRAPHS BY ROB KINMONTH

"No single magic bullet is going to turn the economy around. We are paying for the excesses of the Eighties."

MAURICE R. GREENBERG
American Int'l Group

handling the economy. Democrats can take heart from the Bronx cheer big business gives the President. By a margin of 2 to 1, CEOs disapprove of his efforts or lack thereof. Some complain he was too slow to react to the recession. Others are more troubled by his failure to articulate a set of economic goals for the nation.

Often the criticism is biting. "I don't think that he has a policy," says W. B. Seaton, who is retiring as CEO of American President Cos., a transportation company. "He's just reacting to events as they happen." Adds Finis Conner of Conner Peripherals: "If I ran my company the way he's running the country, I wouldn't have much of a company left."

Even those who oppose fiscal intervention fault Bush for not explaining his position effectively. Says Robert C. Winters, of Prudential Insurance Co. of America: "The President has not been speaking to the people—buying socks doesn't cut it. The captain should not be on the bridge but on the deck reassuring his troops and those depending on him." Robert J. O'Toole of A.O. Smith Corp. faults Bush for his diffident handling of the recession: "For heaven's sake, speak out. The President needs to take a stronger leadership position on the economy." O Great Communicator, where are you when we really need you?

What kind of prescriptions do the patients want from the White House doctor? The executives overwhelmingly endorsed the use of two fiscal measures to get the economy percolating. Fully 82% liked an investment tax credit. Finn M.W. Caspersen of Beneficial Corp., argues that a credit with a fixed duration, say 18 months to two years, would prod people to invest quickly, while also limiting any negative effects on the budget deficit. A solid 74% favored broadening the eligibility for individual retirement accounts. Executives split evenly on whether expanded public works projects would be a good idea.

CEOs gave thumbs down to moves aimed mainly at stimulating consumption. A reduction in the personal income tax was frowned on by 64% of those polled. Says Tyco's Fort: "Running out and doing a cosmetic tax cut, particularly at the expense of the deficit, isn't going to accomplish anything." Still, special-interest proposals of the sort that make free-market fans gnash their teeth can attract large constituencies. More than 40% of the CEOs would welcome bringing back the deduction for interest paid on new car loans. A third, wrapping themselves in the flag, would hail an interest deduction that applied only to cars made in the U.S.

Some CEOs accept that whatever the President does will have to be swaddled in a compromise package. Says Beneficial's Caspersen: "As a political matter, you'll have to include things that benefit the middle class immediately, because other measures—like any kind of investment credit—will take six to nine months to trickle down." Others acknowledge that whatever is done to put the spring back in America's industrial gait won't put the unemployed back to work as fast as people want. Says Maurice R. Greenberg of American International Group: "There is no single magic bullet that is suddenly going to turn the economy around. We are paying for the excesses of the 1980s."

In fact, Bush's laissez-faire approach—the object of so much CEO scorn—has won him praise from the minority, including Greenberg, who approve of his policies. They tell Bush to stick to his guns—or rather, keep his fiscal shooters holstered—even if it takes years for the recession to work itself out. "All this clamoring for government to take over and handle the economy is misguided," says William T. Esrey of United Telecommunications. "We have a free-enterprise system, which is there to manage the economy—why not let it work?" Says American Brands' Alley: "Sometimes the more government does to change the course of the economic cycle, the greater the problems in the future." Most succinct of all is William S. Lee of Duke Power Co.: "The less Washington does, the better."

Despite the pain, the stress, and the uncertainty, several CEOs declared their enduring faith in the American economy and in its ability to struggle back from recession—even a lengthy one, should that be the case. Says American Brands' Alley: "My glass is half full. We expect a record year in 1991. I don't think the U.S. is going to hell in a handbasket, and I believe American industry will emerge stronger than ever from this recession." Adds AIG's Greenberg: "Many before said the thing we have to fear most is fear itself. We should have confidence in the future. This is a great nation!" F

Q A **Do you approve or disapprove of President Bush's handling of the national economy?**

Approve	31%
Disapprove	62%
Not sure	7%

Q A **What should Washington consider to help get the economy moving?**

	Yes	No	Not sure
An investment tax credit	82%	18%	
Expansion of IRA eligibility	74%	24%	2%
Extra public works projects	49%	49%	2%
Bringing back the deduction for interest paid on all new car loans	42%	57%	1%
Personal income tax reductions	35%	64%	1%
Bringing back the deduction for interest paid on new car loans for cars manufactured in the U.S.	33%	66%	1%

THE TYRANNY OF AMERICA'S OLD

By clinging to an outsize share of governmental goodies, the elderly are unintentionally forcing the nation to shortchange its young. Herein some ways to solve the problem. ■ *by Lee Smith*

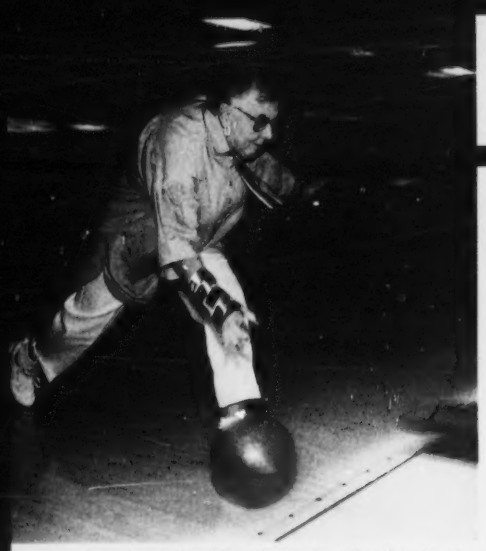
IT IS ONE OF THE MOST crucial issues facing U.S. society. But hardly a politician will even talk about the subject, much less propose remedies for it. The problem? Simply put, America is spending too much on its elderly and too little on its young. Unless something changes, that gap will only widen—with potentially devastating economic and social consequences.

You don't believe it? Here are the facts. Washington, together with state and local governments, spent just over $11,000 in 1998 on every American over 65; they spent only $4,200 on each youngster under 18. Thirty years earlier those proportions were roughly reversed. With only 12% of the population, seniors now command 54% of federal social spending, mainly through Medicare and Social Security. Last year these two programs claimed 5.6% of GNP, a share that will approach 9% over the next 30 years.

Result: In order to pay for the oldsters' Big Rest, other worthy causes, most critically investment in children, increasingly get pushed aside. Head Start, despite its impressive track record, is budgeted to reach only about one-quarter of the 3- and 4-year-olds who live below the poverty line. That means 1.5 million kids will not be able to start school ready to learn. Vaccination funds are so short that only half the 2-year-olds in Hartford and New Haven, Connecticut, have been inoculated against such diseases as measles, tetanus, and tuberculosis, a much smaller percentage than in Algeria or Uganda.

Of the $410 billion to be spent this year on Medicaid, which provides health care for the poor of all ages, about 40% will go to those over 65. The taxes on wages that

Geezers in gear: Seniors, like these Power Riders of Sun City, Arizona, don't look like Hell's Angels. But they can sure scare the folks in Washington.



They bowl, they bike, they help police the streets—and, kids, don't let the sun set on your heads in Sun City. No one under 19 is allowed to live there.

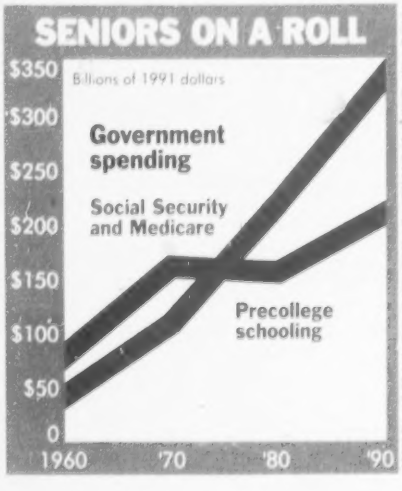
pay for Medicare and Social Security, moreover, leave less money in workers' hands for states and local governments to tap for schools. In almost half the local elections in New Jersey last year, voters rejected the school budgets. Holyoke, Massachusetts, laid off one-third of its teachers after the city's elderly whites refused to dig deeper to underwrite schools filled largely with Hispanic children.

A work force cheated of protein when it is young won't have the muscle required when it matures to keep the economy rolling. That's especially worrisome since today's kids will one day have to feed and nurse an unparalleled army of oldsters—the 76 million baby-boomers born between 1946 and 1964. This crowd begins to hit retirement age in 20 years. By then there will be just 28 workers around to support every ten pensioners on the golf course, down from 33 workers who share that burden today. Will the toilers simply refuse to pay the greens fees? They well might.

If war between the generations does break out one day, Fort Sumter is likely to be a stretch of reclaimed desert northwest of Phoenix. On one side of a dry gulch misnamed the Agua Fria River lies Sun City, a glistening community of 46,000 retirees. No one under 19 is allowed to live there. On the other side is El Mirage, a dusty village of 6,000 or so farm workers.

To lower its property taxes, Sun City withdrew a decade ago from the school district that instructs El Mirage's children. Meanwhile, the federal government continues to pluck $5.60 for Social Security checks and another $1.45 for Medicare from every $100 that the farm workers of El Mirage earn in the onion and cotton fields, plus a matching amount from their employers. Those dollars scamper over the Agua Fria to Sun City, where they support, among other things, gleaming Boswell Hospital. It dominates the cityscape like a cathedral over a medieval town, but El Mirage residents rarely use it, except in occasional emergencies. "A woman delivered a baby here one night," recalls a Boswell volunteer. "There wasn't a diaper in the whole place."

How has a country that used to be accused of spoiling its kids become so recklessly generous with its declining generation and foolishly stingy with its rising one? Management consultant Peter Drucker, 82, blames geriatric avarice: "We are the greediest class in human history." That charge is clearly unfair to many individual elderly. But it accurately characterizes the political stance adopted by Washington's powerful gray lobbies, which take the view that any age-related benefit, once granted, can never be taken away. And when the elderly speak, timorous politicians listen. They know that a high percentage of the old vote—50% more than those age 34 or less in the last presidential election.



True, the programs for the old that now tyrannize Washington were originally launched to address real needs. "'Old,' 'poor,' 'frail,' and 'deserving' used to be synonymous," notes Robert Binstock, a gerontologist at Case Western Reserve Medical School. "So when the New Deal created the old age welfare state, we exempted the elderly from screenings based on need."

EVEN TODAY, plenty of old folk remain desperately poor, as defenders of the status quo are quick to point out. Etta Ruple, 77, resides in the Luxor Mobile Park, off U.S. Highway 41 in Sarasota County, Florida, and a long way from the opulence of the ancient Nile. On a recent afternoon she sat in her 12-by-30-foot trailer, aluminum crutches at her side as she indifferently munched a grilled cheese sandwich and Jell-O. "If I were to die today, I wouldn't fight it," she says.

A dozen hip operations have shortened one of her legs by six inches and left her in pain. Mrs. Ruple started working as a hairdresser at 14 and during an active business career owned in succession a couple of grocery stores and several cocktail lounges in the Midwest. Her husband, a tool-and-die maker, died shortly after they moved to Florida in 1968. She managed the mobile home park until her crumbling hip crippled her. "We had some money when we came here, but when you're in the hospital as often as I've been, you go through it, even with Medicare," she says. She lives on a $600-a-month Social Security check, and for her the rise in the cost of a macaroni and cheese dinner from 99 cents to $1.39 over the past three months has been a significant economic event.

But now the deserving elderly poor like

REPORTER ASSOCIATE *Suneel Ratan*

PHOTOGRAPHS BY ALON REININGER—CONTACT

The old have lots to give: Bennie Mohown, 67, helps Leshawn Mathis, 12, in Hartford, Connecticut.

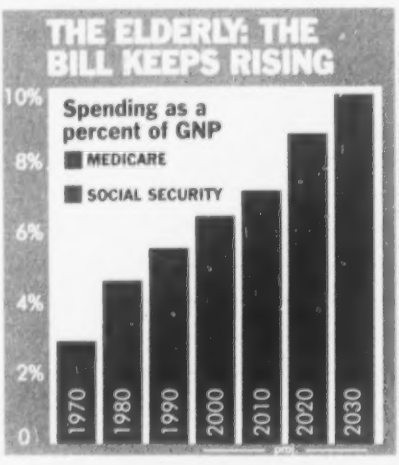
Mrs. Ruple are a minority. The cure has worked. Since 1960 the number of seniors below the poverty line has shrunk from 35% to about 12.2%. That's slightly less than the 13.5% of the total population who qualify as poor—and considerably less than the 20.6% of those under 18 who are poor.

THOSE WHO would continue to tie benefits to birthdays must also acknowledge the existence of places like Longboat Key, an island of graceful fairways and handsome homes off Sarasota's coast, and just a few miles away from Etta Ruple's trailer. "There's no recession here," says Mayor James Brown, 70, a retired newspaper executive. Brown and his wife, Marjorie, sold their house in Ann Arbor, Michigan, for exactly the $65,000 they paid for their home in Longboat Key. They get along comfortably on a total income of just $29,000 a year.

"It's amazing how well you can live once you've put your three kids through college and have no mortgage," says Brown. "These really are the golden years." On Longboat Key the major domestic issue is whether guests at the hotel have the same rights as homeowners in reserving tee-off times. Elderly dandies at the Posh Nosh restaurant banter about the delights of Hawaii in March.

James P. Durante, 77, who lives in a $400,000 condominium in Longboat Key, resembles Etta Ruple of Luxor Mobile Homes only in age and a lifetime of hard work, in his case as a partner in the New York City law office of Fulbright & Jaworski. Like Mrs. Ruple, he pays just $380 a year for Medicare insurance. He's in pretty good health, so he doesn't use it often.

Because he waited until he was 70 to retire, Durante receives an extra-large Social Security check of $1,700 a month. "I'm overpaid tremendously," Durante maintains in a lively voice that retains the gravelly sound of his native Brooklyn. "In a couple of years I got back everything I ever put into the system." Durante is not a selfish man. He and his wife, Joan, give away time and money to local theater groups, the symphony orchestra, and other good works.



BUT A SYSTEM that continues to award windfall returns to the well-to-do cannot be sustained without placing a crushing burden on younger generations. Start with Medicare. General tax revenues and nominal premiums from the elderly pay doctors' bills. A 2.9% tax on workers' wages up to $130,000 covers hospital expenses. Even so, rapidly rising hospital costs are going to overwhelm Medicare by 1995. At that point Congress may have to notch up the payroll tax once again.

Social Security's pension expenses will be manageable for a while longer. The combined employee and employer contribution of 11.2% of payroll (which is in addition to the 2.9% for Medicare) should generate some $290 billion this year. That's more than enough to mail out checks to Durante, Ruple, and 25 million others, pay for a 3.7% annual cost of living increase, and still generate a surplus of $60 billion in 1992 alone. In turn, the Social Security trust fund will lend this excess to the federal government to cover everything from interest payments on the national debt to crop supports and AIDS research. In exchange the Treasury gives Social Security IOUs, which some commentators continue to confuse with cash that tomorrow's old can live on. In reality these are merely more debts, accruing interest at 8% or more a year, which future taxpayers will have to make good on.

From the beginning Social Security has operated as a pure transfer payment. This arrangement was painless as long as the ranks of the retired were thin. When Ida Fuller, the first beneficiary, left her job in 1940, she had paid a total of $22 in FICA taxes, matched by the Vermont law firm for which she was a clerk. She lived long enough to collect $20,000. In Ida's days of leisure 42 workers toiled for every retiree.

Skip ahead to 2030 when nearly all the boomers have quit their jobs. The ratio of workers to retirees will have sagged to 2.4 to 1, a staggering weight on both the employed and their employers. On average the 65-year-old retiring now will receive in his first year 42% of what he earned in his last year on the job. To bankroll pensions and hospital care at the current level after baby-boomers retire, tomorrow's workers may

have to give up 12% of their salaries—and employers will have to match that contribution. "Employers are going to be forced to trim labor forces drastically," predicts Stephen Entin of the Institute for Research on the Economics of Taxation. "This could cost the economy 15 million jobs."

At best, those now under 30, the baby-busters, will get no more out of Social Security than the amount they contribute. That's a far cry from current retirees' deal, a shortchanging young people sense even without working through the numbers. Polls indicate that 70% of those under 30 believe that Social Security's treasury will be empty by the time their turn comes. Says Douglas Coupland, 30, author of *Generation X*, a novel about disaffected youth today: "The last penny will be spent on a jewel-encrusted stereo system for Robin Williams's walker."

What America needs now, before the cold war between the generations heats up, is a major rethinking of the social compact between the old, mid-liters, and the young. Here are a few modest reforms that should protect people like Etta Ruple, deal justly with James Durante, and still ensure that the kids of El Mirage and other youngsters get a fair shake.

■ **Encourage more links between the old and the young.** Local real estate agents do not want to hear that Sun City, Arizona, and its nearby companion, Sun City West—rows and rows of suburban ranch houses that sell for $50,000 up to $200,000—are "retirement communities." No, no, they insist, these are "active adult communities."

They have a point. Though few of the residents still have paying jobs, most stay very busy enjoying the 18 golf courses, 64 bowling alleys, 79 pool tables, and ten arts and crafts workshops. Some even pick the palm-lined streets clean of trash. Hundreds volunteer at Boswell Hospital. Others join the Posse, a civilian patrol that keeps an eye out for crime and reports suspicious activity to the county sheriff's office.

Still, these healthy, civic-minded folks could extend even more generosity beyond the white stone wall that surrounds their community. Those on the other side are inclined to see them as selfish and bullying. Tom Patterson, Republican leader of the Arizona Senate, points out that because such a large percentage of the elderly vote, the two Sun Cities dominate all three of the legislative districts they are part of. "For them taxes are the No. 1, 2, and 3 issues," he says. The state ranked 34th in the nation in spending per school pupil in 1989.

Elderly people on fixed incomes are understandably worried about rising expenses. But they have plenty of free time to give away. Troubled children in particular take readily to old mentors, maintains Ellyn Neises, a criminal justice specialist at the Clark Foundation in New York City. Middle-aged advisers seem to remind the kids of police and authoritarian parents.

Some Sun City residents do volunteer. Roy Fritz, 76, an entomologist formerly with the Public Health Service, spends every afternoon at El Mirage Elementary, one of the institutions Sun City officially divorced when it voted itself out of the school district.

Fritz teaches math and reading to gifted students. "The people who didn't do much in life and don't do much in retirement are those who pass away first," he says. Several dozen other Sun Citizens tutor at least a couple of times a week. Around the country thousands of elderly, people like Bennie Mohown, 67, of Hartford, who has worked with disabled and chronically ill children for the past three years, also extend a hand to the younger generation.

THE KID GAP

Per capita government spending in 1990

El Mirage and schools like it could use many more volunteers. "We're not looking for crossing guards," says superintendent Frank Galas, 51. "The people of Sun City have a lot of talent: lawyers who could take over our legal work, computer specialists who could teach skills to our high school students. I want to make a deal with them. If they will teach our students during the day and find them jobs, I will keep these kids from robbing their homes at night."

■ **Delay the retirement age.** By stipulating that people qualify for Medicare and full Social Security benefits at 65, Washington has made that the beginning of old age. But the biological clock tells a very different time. People who have been healthy most of their lives generally don't begin to decline rapidly until their late 70s. Only 1% of 65-year-olds suffer from Alzheimer's, for example, whereas at least 20% and perhaps as much as 40% of those over 85 suffer from the disease. Treating both age groups the same is like mothering teenagers as though they were toddlers.

Already Congress has voted to shift the age of eligibility. Today's 35-year-olds will have to wait until they're 67 for full Social

Roy Fritz, 76, tutors elementary school students like Niqui Goodloe in El Mirage, Arizona.

Security benefits. That's the right idea, but it doesn't go far enough. The payout should be structured to encourage people to stay on the job until they are 70. With more older workers paying into the system and fewer taking out, Social Security would be billions of dollars richer.

■ **Slow Social Security increases.** A dismayingly complex formula determines starting pay for the rookie retiree. Social Security not only computes his lifetime earnings but gives credit for growth in wages over his working years. Say he made $250 in January 1962. Wages have soared by a factor of five since then, so $1,250 goes into the equation for that month.

But suppose the formula were based on price increases instead. Prices have only quadrupled since early 1962, so $1,000 instead of $1,250 would be the January 1962 entry. Assuming that wages in the future grow faster than prices, Social Security could save still more billions. Each new class of retirees would start off better than the previous year's but not by quite so much.

■ **Tax wealthy retirees.** Should Social Security checks be restricted to the needy and denied to society's successes? "I'd scream breach of contract," says Durante of Longboat Key. Eventually the payouts may become such a burden on future workers that the benefits will have to be reserved for the poor. In preparation for that day, baby-boomers should start now to save more on their own and think of Social Security as fire insurance, collectible only if their nest eggs get fried.

At the moment, means-testing Social Security is such political dynamite that no politician who hopes to stay in office dares to embrace it. The prudent course is to increase the income taxes of Durante and his cohort. Currently retired couples with a total income of less than $32,000 pay no tax on their Social Security checks. Those above that ceiling pay taxes on half of what they receive. The well-to-do ought to pay taxes on 85% of their Social Security income. (The exempt 15% represents roughly what recipients have paid into the system over the years.)

Also, just as higher-paid employees at many corporations are required to foot more of the bill for their health insurance, the wealthy could afford to pay higher premiums and absorb bigger deductibles for Medicare. The Bush Administration reportedly will recommend in its next budget that annual premiums for those with incomes over $125,000 be lifted to about $1,200, more than triple what they now pay. Still, with Medicare's hospital fund headed into deficit by 1995, that's far too modest. Drop the ceiling to $50,000 and raise the premiums for the top earners even higher.

One Foot in the Grave: a Sun City rock band whose members are all golden oldies

■ **Consider rationing health care.** Medical machinery and drugs developed to restore health are sometimes misused to drag life on. For example, a 90-year-old man with Alzheimer's disease so advanced that he doesn't know where he is much of the time suffered a heart attack and collapsed not long ago. Doctors at New York City's Bellevue Hospital revived him and suggested to his son that they could insert a pacemaker, a procedure that costs $16,000. But why? Won't he ever be allowed to die?

Daniel Callahan, 61, director of the Hastings Center, a research institute that muses on medicine and ethics, points out a philosophical contradiction that is peculiarly American. "We are taught that death gives meaning to life," Callahan observes. "Yet our doctors refuse to acknowledge any disease as a legitimate cause of death." Europeans are more resigned to their mortality. British doctors decline to prescribe expensive kidney dialysis for patients over 50.

Perhaps Medicare should put age limits on major surgery, such as $40,000 coronary bypasses, and exotic drug regimens, such as treatments for septic shock that run $3,000 a dose. Those who might want damn-the-cost-keep-me-alive intervention after the age of 75, say, would have to start buying insurance to cover the heroics in their 40s or 50s.

Compared with other tyrannies that the U.S. has successfully bested, breaking the tyranny of the old seems relatively painless. Most of the reforms above would barely pinch today's elderly because they are intended to control future benefits. For their part, boomers who want to reserve a few decades on the fairway for the end of their lives can do so, if they are willing to sacrifice and start saving more. The real challenge: to reset attitudes and reapportion money so that today's children have the same chance for success and prosperity as the generations that have recently gone before them. F

Still, as Abe Cohen knows, walking the dog just isn't the same at 81.

THE GREAT PENSION ROBBERY

States and cities are plundering employee pension funds to ease their budget crises. Taxpayers may be stuck if the plans can't meet their future obligations.

■ *by Alan Deutschman*

WHILE BANKS, S&Ls, insurance companies, and nearly everyone else in the financial services industry has a case of the shorts, America's public employee pension funds have an embarrassment of riches. And like a lot of wealthy folks, they are becoming the victims of holdup artists. With ever more states and cities facing nasty budget deficits, the politicians who run them are trying to grab some of the $878 billion set aside to pay for the retirement of teachers, firefighters, police, sanitation workers, and other public employees.

The pilfering of the golden nest eggs is alarmingly widespread. In the past two years more than a third of the states have cut or delayed contributions to their pension funds, seized money outright from pension accounts, or begun to debate similar measures. This is no time to be confiscating pension assets. While contributions have fallen slightly over the past three years, payouts to pensioners have been rising sharply (see chart). As a result, cash flow—the difference between annual contributions and benefits paid over the year—has narrowed for the public funds, to $6 billion from $16 billion. According to Chris McNickle of Greenwich Associates, a research firm that compiles data on pension funds, the gap could shrink to $2 billion or less by the end of 1991.

The immediate victims of any cut in contributions or attachment of assets are the public employees whose retirement funds are being raided. But taxpayers may be on the hook too: They could have to make up the difference if, thanks to the raids, public plans lack the wherewithal to pay retirement benefits in the future.

The most egregious assault on pension funds occurred in California last summer. As the July 1 start of the fiscal year neared, Republican Governor Pete Wilson was staring at a $14 billion budget deficit. So to help make ends meet, Wilson decided to take $1.6 billion from the coffers of the $63 billion California Public Employee Retirement System. Known as Calpers, the fund covers most state workers except teachers, who have their own plan. Wilson also tried to replace the 13-member Calpers board with a new nine-member group that he would control. Dale Hanson, the system's irate chief executive, called this scheme a "hostile takeover."

The backlash against the governor came immediately. State employees blocked the driveway to the capitol's garage to protest looting the fund and packing the board, and they overwhelmed their representatives with calls, telegrams, and visits. Wilson threatened them with salary reductions, furloughs, and layoffs of up to 20,000 workers if they succeeded in foiling his plans. Robbery and blackmail, cried Fortney H. Stark, the liberal Democratic Congressman from Oakland. He accused Wilson of conspiring to turn workers' savings into a "giant slush fund" that would "hide the real cost of government."

In the end, the California legislature prevented Wilson from reconfiguring the board but let him have the $1.6 billion from the pensioners' cost-of-living account anyway. California's Third District Court of Appeals will decide on the constitutionality of the legislators' action by March or April.

The Illinois Supreme Court is hearing a similar case. As the hot Springfield summer wore on, Illinois legislators, anxious to adjourn, were desperately hunting for money to comply with the state's balanced-budget requirement. Rather than making tough choices, they told Republican Governor

Tap the funds: California Governor Wilson hit the state pension plan for $1.6 billion to patch his budget.

Jim Edgar to take up to $50 million from the state's 250 "special funds," which under the law must be spent on specific purposes like schools, roads—or pensions. Edgar seized $21 million from the five state retirement systems, making no promise to repay the money, and used it to shore up the general-revenue account. A court ruling on the constitutionality of this move is expected soon.

The Illinois snatch is particularly nasty because the public employee pension plans, unlike Calpers, were underfunded to start with. Assets covered only 46% of the present value of projected obligations for judges on up to 65% for teachers. By comparison the national average for public retirement systems is around 80%; private pensions, which are subject to the tough Employment Retirement Income Security Act rules, must strive to be fully funded. Ironically, Illinois passed a law in 1989 requiring itself to push toward full funding of its public plans by 1996, and then fell short by a total of $500 million in employer contributions in 1989 and 1990.

Not so fast: New York comptroller Regan says pension assets should not be used for budget balancing.

MOST ATTEMPTS to siphon money out of public employee pension funds are far more subtle than those in California and Illinois. Typically a city or state will play around with actuarial assumptions on which the funding and the investment objectives of its plan are based to reduce the contributions required. Here's how this works: With the help of historical tables on life expectancies, inflation rates, and so forth, actuaries determine how much money a pension plan will need years from now in order to pay benefits to future retirees. This work requires developing complex forecasting models based on an array of assumptions. For example, how much will salaries increase? Will employees opt for early retirement in ever greater numbers?

One of the most crucial projections is the annual rate of return on the pension plan's invested assets. The power of compound interest means that a seemingly small improvement in annual returns—say, 8.25% vs. 8%—adds up to a lot over 25 or 30 years. Thus, a marginally higher projection for the rate of return means that an employer can drastically reduce the sums it must put into a plan. A basic rule of thumb: If you increase the expected rate of capital appreciation by one percentage point over 30 years, an employer can cut its current contributions to the fund by 20%.

Louisiana saved $11 million last year in contributions to its teachers' retirement system by upping the projected return from 7.5% to 8.25%. Missouri netted some $20 million by going from 8% to 8.5% last year on its state employees fund. New York City boosted its rate-of-return assumption for city employees from 8.25% to 9% in the winter of 1990, which saved $40 million for the Transit Authority alone and enabled it to hold bus and subway fares to $1.15.

Years from now, if the projections for investment returns turn out to have been too optimistic and the plans no longer have enough money to pay benefits, the politicians who instigated the changes will no longer be in office. Taxpayers could well be stuck writing the monthly pension checks for legions of retired civil servants. But it is difficult for employee advocates to fight these changes because actuarial math does not make for vivid public debate. Depending on the full set of assumptions—salary and payroll increases, early retirement, retiree mortality—a range of returns could be deemed reasonable to provide sufficient funding for the future. In 1989 the targets used by public retirement systems varied from 5.5% a year to 9%, with 7.8% as the mean.

Clearly, 5.5% is too conservative. And, granted, a shrewd outfit like Calpers earned a hefty 12% annually over the last half of the Eighties. But is it so certain that the historic 1980s run-up in stock and bond prices will be repeated in the Nineties and beyond? Hot decades for stocks are usually followed by cool decades, and corporate pension managers certainly haven't rushed to increase *their* projected returns. Most recent adjustments in public-fund contributions bear the unmistakable mark of the worst kind of politics. In a fall 1991 survey by *City & State* newspaper, 11 out of 28 of the largest funds said their actuarial assumptions were adjusted upward over the past two years, many in response to political pressure.

TEACHERS, the beneficiaries of several of the largest pension systems, have been especially hard hit by political shenanigans. In 1990, New York State, facing a $3 billion deficit, withheld $850 million of contributions to teacher pensions. By switching to a new way of calculating the funding, California is reducing payments to its teachers' retirement system for ten years, including a $400 million cut this year, while planning to make up for the shortfall through sharply higher contributions after 2001. Talk about passing a burden to future generations!

Texas is reducing contributions to teacher pensions by $85 million over the next two years, boosting the system's unfunded liability to almost $4 billion. The state comp-

REPORTER ASSOCIATE *Mark D. Fefer*

troller has even tried to wrest control over state pensions from an independent board and give it to a committee consisting of the governor, lieutenant governor, and—you guessed it—the comptroller himself.

THE QUESTION of whether pols have the right to put their hands in these cookie jars begs a more fundamental question. To whom does the public employee pension-fund money really belong? The answer: to the beneficiaries and to no one else—not to the state or to the public at large. A pension fund's assets represent deferred employee compensation and thus constitute private property. Pension trustees are the the guardians of this property.

But the trustees are often appointed by elected officials or must run for office themselves, so they are apt to give in to pressures that allow the funds to serve political objectives at the expense of the pensioners. Wrongly so, argues Edward Regan, New York State's Republican comptroller and sole trustee of the state's $44 billion retirement system: "Do public officials have a right to use pension fund assets for budget balancing and other government purposes? The answer is a clear no." Regan, however, is at odds with Governor Mario Cuomo, a Democrat, who is eager to have pension funds make investments for the purpose of enhancing the economy of New York State.

In bona fide fiscal emergencies, the enlightened self-interest of current employees and retirees might dictate lending some pension plan assets to their imperiled employers. Otherwise, the bankrupt state or city might not be able to pay benefits to its retirees at all—and might have to fire large numbers of government workers. New York City's pension funds invested in municipal bonds as part of Gotham's mid-1970s rescue. But the trustees were able to demand a 9% rate of interest, several percentage points higher than the prevailing rate for tax-exempt issuers. They also received federal guarantees of repayment and special immunity from their fiduciary obligations that would normally prevent them from investing in a related party or one with a poor credit rating. The arrangement clearly worked out well for the city and for the pension funds.

Detroit essentially copied the New York example during its financial crisis of 1981. So did Philadelphia in 1991. Its credit rating having fallen below investment grade, Philadelphia could not continue its annual practice of selling short-term tax-anticipation notes in the fall and paying them off in the spring when tax revenues flowed in. So the city turned to its pension funds in January for $37.5 million in loans as stopgap financing. The pension trustees, serving as lenders of last resort, exacted a brutal toll: the prime rate plus fees equaling around 2% of the principal. The city paid off the loans by April 15, giving the pension funds an annualized return of 27%. Without that exceptionally high return, the fiduciaries would not have been able to justify the risk.

J. Chester Johnson, president of Government Finance Associates, a New York City consulting firm, advised Philadelphia on the transaction. In his previous job as a Deputy Assistant Treasury Secretary, he oversaw the federal government's loans to New York City in the 1970s. He says that governments should consider borrowing from pension funds only in "desperate circumstances." Such cases would include helping out a municipality close to bankruptcy or an issuer that had lost its investment-grade rating and had dire cash-flow needs with no access to capital markets.

Does either of these circumstances fit California, the eye of the current storm? It is hard to believe Governor Wilson, who justifies the pension raid as "urgency legislation," when he argues in his brief to the court of appeals that California's fiscal crisis threatens the state's "ability to provide and fund for essential services." Although recently downgraded by Standard & Poor's, California still has that coveted triple-A credit rating from Moody's. It all goes to show that politicians will say almost anything to get their mitts on somebody else's cash.